

CAPITAL RESOURCES REVIEW 3

1. INTRODUCTION

Article 5.3 of the Agreement establishing the Bank specifies that “The Board of Governors shall at intervals of no more than five (5) years review the capital stock of the Bank”.

The last review by the Board of Governors of the capital stock of the Bank took place in 2001. Therefore, the Board of Governors has the statutory duty to conduct the present Capital Resources Review (CRR3) in 2006 to cover the period 2006-2010.

To assess the Bank’s operational strategy and capital adequacy for the next five years, the Bank has carried out a thorough analysis of:

- operational and financial results and transition impact achieved during the period of the second capital resources review (CRR2) 2001-2005;
- expected economic outlook and risks;
- medium term strategic objectives for the Bank for the period 2006-2010;
- transition challenges ahead;
- indicative projections of the Bank’s activities in areas and sectors of operations;
- indicative projections of the Bank’s future resource framework and financial performance during the CRR3 period; and
- headroom, BIS2 ratios and economic capital.

The Annex to this document provides a comprehensive and well-founded analysis on which to base the strategic directions of the Bank over the period 2006 to 2010 in terms of transition objectives, operational activity, risk, financial performance and resource requirements.

The Board of Directors wishes to express its appreciation for the high quality of the analysis produced by Management, as well as for the inclusive and participatory consultation process with Management. The review has been exhaustively discussed at a series of meetings of the Financial and Operations Policies and Budget and Administration Committees of the Board of Directors.

2. OVERVIEW

The EBRD Board of Directors considers the Bank to be a highly successful and effective International Financial Institution. It has delivered on its mandate to foster the transition towards open market-oriented economies and promote entrepreneurial initiative in all its countries of operations. In the fifteen years of its existence it has become firmly established as the region’s largest single investor with unparalleled expertise in financial instruments, risk management and local knowledge across a wide range of industries and sectors, with a particular focus on the private sector. Its policy dialogue with governments and market players is a valuable instrument in implementing international policy goals commensurate with its mandate.

Over the five year period of the CRR2, the EBRD exceeded all strategic projections and targets – on transition impact, business volume, profitability and catalysing private sector finance - whilst spending considerably less on the Budget of the Bank than planned. The Board of Directors considers this to be a highly significant achievement and congratulates the Staff and Management of the Bank.

Looking forward, it is important to keep in mind that much of this success depends also on the cooperation of donors who enable the Bank to play its pioneer role. It depends too on the willingness of the countries of operations to pursue sustained reform and subscribe to the principles of multiparty democracy, pluralism and market economy set out in Article 1 of the Agreement Establishing the Bank.

After considerable economic turbulence in the early years of the Bank's existence, the Region has benefited from a period of unprecedented economic stability and growth. Analysis suggests that important transition challenges remain in all the Bank's countries of operations. However, it is clear that the international and regional context is now very different to what it was in 1991, and the mandate of the EBRD must be applied in this new context, as the Bank responds to market conditions by shifting south and east. Enhanced cooperation with donors and other IFIs active in the region will be essential to maximise impact in this evolving environment.

At the same time new international policy issues arise to which the Bank must respond. An enhanced focus on issues of corporate governance and integrity in the region is already being pursued, a challenge of particular relevance as economies mature and participate increasingly in the global economy. The Bank has developed new structures to work with donors in its poorest countries of operation, adapting to difficult transition challenges. Most recently, it is clear that the Bank must enhance its contribution in the energy sector, and particularly to energy efficiency, and make a leading contribution to this policy priority in the region.

The Board has every confidence in the Management of the Bank to implement the strategic orientations set out below, responding flexibly to evolving conditions whilst staying true to its mandate.

3. REVIEW OF CRR2 PERIOD (2001-2005)

The Board of Directors notes with satisfaction that the Bank has achieved, and in some areas exceeded, the strategic objectives set in the CRR2. Cumulative **business volume** has exceeded CRR2 projections over this period by 27% reaching €19.6 billion. In line with a key strategic objective of CRR2, the Bank has increased the share of the portfolio in the early and intermediate transition countries and Russia to 72% by end 2005 compared with a CRR2 projection of 68%.

Cumulative operating **profit** over the period has reached €2.5 billion, over three times the CRR2 base case projection reflecting higher realised and unrealised portfolio returns and lower provisions than planned. As a result, total reserves reached €4.7 billion by end 2005 including significant unrealised gains. Unrestricted general reserves reached €1.7 billion compared with an original projection of €1.1 billion, thus contributing to the strengthening of the risk-bearing capacity of the institution.

While CRR2 included a budget growth framework of 4% in real terms, the Bank has extended in practice its record of **zero real budget** growth throughout the CRR2 period with the 2005 Budget representing the eleventh year of no real budgetary growth. In real terms, the Bank's budget decreased by 9% since 1994 while the portfolio quadrupled in volume.

A comprehensive assessment of the **transition** impact of EBRD's activities over the last five years plus the finding of evaluation studies demonstrate that the Bank has had a significant impact on transition. This effect has been shown during all stages of transition. EBRD has been particularly successful in Central, Southern and Eastern Europe and in its support of micro and small businesses, of the banking sector and of the power sector. Directors welcome these achievements. Important lessons of experience are reflected in the proposed orientations for CRR3.

4. CONTEXT AND ASSUMPTIONS OF CRR3 (2006-2010)

Directors have taken the strategic view that the following elements form the context for CRR3:

- Transition challenges remain across countries of operations. However, the transition range across the region has grown wider and more differentiated as the gap between early and advanced transition countries has further increased during CRR2.
- The EU-8 countries will graduate during the CRR3 period as multiparty democracies and open market-oriented economies. The role of the Bank is not to maintain a given level of business in these countries, but to manage the completion of the EU-8 transition process and of the Bank's activities and presence. After graduation, the Bank will stop doing new business in those countries, while ensuring that existing projects are carried out in conformity with Board decisions.
- The operating environment of the Bank is becoming increasingly challenging. As the Bank continues to shift its activities east and south, the business environment becomes more difficult, as local counterpart experience tends to decrease and integrity concerns tend to become more frequent.
- The need to foster a more favourable business environment within countries at an earlier stage of transition will require a more active and direct policy dialogue activity in cooperation with other International Financial Institutions (IFIs), which are increasingly present in early and intermediate transition countries and Russia: World Bank, IFC, EIB and ADB.
- Current market conditions are characterised by a very high level of liquidity running ahead of progress in transition in a number of countries of operations. This means that in spite of significant remaining transition impact opportunities, additionality constraints are reducing the need of the Bank to support projects with transition impact.
- Although current conditions, including existing levels of liquidity in the financial markets, may not last over the CRR3 period, the Bank's role will be to manage the final stages of the EU-8 countries' transition process, notwithstanding future changes in liquidity or other market factors, and to fully pursue transition opportunities in countries of operations to the East and South-East.

- The risk environment has been unusually benign for most of the CRR2 period. Impairment levels in higher risk countries have remained below expected levels. This may not remain the case for the CRR3 period. As the Bank increases its activity in higher risk countries and projects, the impact of risk on provisions and financial returns is projected to rise.

Directors agree key assumptions underlying the development of CRR3:

- within its overall mandate, the Bank will rigorously apply its operating principles of transition impact, sound banking and additionality in accordance with approved policies;
- the Bank is projected to be active in its countries of operations in accordance with the above operating principles, respecting Article 1 of the Agreement and applying the Bank's Policy on Graduation while recognising that the CRR3 will witness the management of the final stages of the EU-8 transition process;
- as in CRR2, CRR3 focuses on the proposed utilisation of the existing capital and does not foresee a capital increase;
- the transition mandate of the Bank requires constant innovation and product development; and
- in line with its record to date, the Bank will maintain a sustained focus on productivity, cost control and redeployment in implementing the CRR3.

5. CRR3 STRATEGIC OBJECTIVES

Much has been accomplished during CRR2, yet very important transition challenges and opportunities lie ahead across the region. With these in sight, Directors agree that strategic objectives of the Bank during CRR3 are to:

- actively sustain the transition focus and medium term transition impact of the Bank's portfolio;
- generate and implement projects to support the stronger focus of the portfolio towards the early and intermediate transition countries and Russia;
- develop a product range relevant to the implementation of its mandate within a changing transition and business environment;
- maintain a high quality portfolio in terms of transition, operational and financial parameters;
- expand the operational reach of the Bank into individual regions of the countries of operations; and
- renew the business model to implement effectively and efficiently the above strategic directions.

The Board of Directors acknowledges the need for a change in the business model of the Bank in order to accomplish these objectives, and agrees with Management on the need to ensure the appropriate capacity to lead and implement this change.

6. CRR3 NEW BUSINESS MODEL

To operate effectively and efficiently in this more complex operating environment, the Bank must continue to evolve its business model. The successful implementation of the CRR3 in this changing environment will require substantially more specific annual business plans, starting in 2007, to be approved annually by the Board of Directors. The annual business plan should enable shareholders to assess the opportunities, benefits, costs and resource allocation related to the Bank's development as well as to measure the Bank's performance in implementing the approved business plan. Directors agree the main elements of this model as follows:

- Adapt its core banking activity to evolving transition challenges and business opportunities. Main objectives are to:
 - develop the product range of the Bank to address a wider differentiation of country priorities and market conditions across the region, including capital market-based project financing solutions, enhanced utilisation of local currency financing, and the increased use of instruments developed in the context of the ETC initiative;
 - maintain a proactive policy dialogue in support of transition and of improving the business environment of operations in individual countries; and
 - develop risk-taking approaches relevant in the new environment and maintain effective handling of integrity issues.
- Develop the competence to address new challenges such as:
 - the weak capital base of enterprises and financial institutions which is a key constraint to economic growth through a significant increase of equity investment;
 - underdeveloped infrastructure required for the effective functioning of a market economy through public private partnership solutions and other relevant instruments; and
 - a renewed and expanded approach to energy efficiency activities and investments that reduce emission of greenhouse gases, including carbon credit facilities, given the significant opportunities for the region and the Bank's potential to contribute to addressing this global issue.
- Ensure appropriate controls within a higher risk environment. The Bank's business is likely to be subjected to increased risk, uncertainty and volatility which require appropriate controls in terms of:
 - risk management, particularly with regards to the transaction credit analysis and portfolio review function;
 - internal controls and operational risk management given the increased volume and complexity of activity;
 - strengthen monitoring activity in light of increased complexity of projects and operating environment and ensure monitoring of non-credit aspects such as transition and environmental conditions;
 - compliance and internal audit functions; and
 - project evaluation.

7. HUMAN RESOURCES STRATEGY

This renewed business model, essential for the successful delivery of CRR3, needs to be underpinned by a comprehensive human resource strategy based on work already being undertaken and developed in a consultative process with staff.

As part of this strategy, Directors agree the need to:

- build up required staffing across the Bank to generate, process, monitor and control an increased flow of projects and portfolio;
- establish an appropriate skills base to deliver the product range required to implement the strategic directions; and
- ensure staff are appropriately deployed between headquarters and resident offices and motivated with a suitable incentive mechanism.

8. CRR3 OPERATIONAL PRIORITIES AND BUSINESS PROJECTIONS

Directors noted the comprehensive assessment of transition challenges, which shows that there remain transition challenges across EBRD countries of operations. Directors broadly endorse the proposed priorities for operational activities at a geographical and sectoral level.

Directors have agreed a set of annual business volume and portfolio projections. These are built around a central case with detailed sensitivity analysis. The Board of Directors is fully aware of the uncertainties inherent over the CRR3 period and the evolving reality in the Bank's countries of operations. The Board of Directors wants to stress that these projections are indicative and must be implemented in a flexible manner consistent with the Bank's underlying operating principles. There is potential for an upside to these projections, as indeed was realised during the CRR2 period for annual business volume.

Operational objectives are:

- to achieve an **annual business volume** within an operating range of €3.3 to €3.9 billion, representing an increase in cumulative business volume of 23% compared to that projected for the CRR2 period. The geographical composition of the annual business volume is projected to shift in line with the strategic direction of CRR3, as indicated by the tables immediately below. The annual number of projects is projected to rise over the period. While the trend towards lower average project size is projected to continue as the Bank's operations move further east and south, the Bank will continue to stay actively engaged in the delivery of large projects, as appropriate. The number of such projects provide upside potential for the operational projections;

CRR3 geographic composition of annual business volume

€million	2006	2007	2008	2009	2010
Early/Intermediate	2,000	2,000	2,050	2,050	2,050
Russia	1,150	1,300	1,400	1,500	1,600
Advanced	550	450	350	300	250
Total	3,700	3,750	3,800	3,850	3,900

CRR3 geographic composition by annual business volume share

%	2006	2007	2008	2009	2010
Early/Intermediate	54%	53%	54%	53%	53%
Russia	31%	35%	37%	39%	41%
Advanced	15%	12%	9%	8%	6%

- to develop the **portfolio** with a base case objective of €21.9 billion by 2010 with a significant growth of the number of operations from around 1,200 in 2005 to around 1,600 by 2010; and
- for the portfolio share of the early and intermediate transition countries and Russia to grow to around 87% by 2010. The geographical composition of the portfolio is projected to shift in line with the strategic direction of CRR3, as indicated by the projections of the tables below.

CRR3 portfolio geographic composition by volume

€billion	2006	2007	2008	2009	2010
Early/Intermediate	8.6	9.4	10.2	10.9	11.5
Russia	4.8	5.5	6.2	6.9	7.6
Advanced	4.2	3.9	3.5	3.2	2.8
Total	17.6	18.8	20.0	21.0	21.9

CRR3 portfolio geographic composition by share

%	2006	2007	2008	2009	2010
Early/Intermediate	49%	50%	51%	52%	52%
Russia	27%	29%	31%	33%	35%
Advanced	24%	21%	18%	15%	13%

9. RESOURCE FRAMEWORK

Directors accept the analysis of cost pressures and staff requirements that will increase as the Bank implements CRR3. They therefore acknowledge that the Bank's budget framework will need to increase in real terms. A real budget growth of 13% over the rate of RPI inflation is proposed as a base case over the CRR3 period within a range of 9% to 18% real growth over the period.

On the basis of its strong resource management experience and track record, the Bank will continue vigorously to seek further productivity gains and to redeploy its resources. However, after 11 years of zero growth budgets and a significantly expanded workload a measured degree of resource growth is necessary to address the

expanding portfolio of increasingly complex projects. This will be used to strengthen resources for the countries to the East and South-East. The Bank will reallocate resources at HQ, strengthen existing resident offices and open additional resident offices to take advantage of transition opportunities in these countries.

Specific resource requirements will be determined in the context of each annual budget based on a detailed assessment of transition, additionality, operational activity, and productivity trends.

Within this approach, the resident office network and staffing requirements will continue to be reviewed in the context of annual budget preparations. The aim will be to ensure that the Bank will optimise cost-efficiency, deploy resources in line with evolving business needs and key priorities, and be responsive to transition opportunities in strict adherence to its operating principles. This approach will be applied across all countries of operations. CRR2 trends, together with CRR3 projections and analysis, point to an expansion of resident offices further south and east, already being pursued in the 2006 budget. The same trends and analysis point to a consolidation of the resident office network in Central Europe, including the creation of regional hubs and closure of some offices. These decisions will be taken in the context of the annual budget preparation process, starting with the Budget for 2007, and will continue over the CRR3 period. In this context, some resident offices will be closed in 2007.

Donor funded technical cooperation will have a growing role in the delivery of the Bank's strategic objectives during CRR3. Given that unrestricted general reserves are projected to reach 10% of authorised capital in 2006, the Bank will consider to directly fund some specific selected technical cooperation activities, including TAM-BAS and legal transition, to catalyse additional donor funds and to support activities where donor funds are insufficient.

10. FINANCIAL PROJECTIONS, CAPITAL UTILISATION AND ADEQUACY

Financial projections anticipate that the Bank will continue to build up reserves during the CRR3 period based on accumulation of annual profits. The strengthening of reserves during CRR2 and projected further growth during CRR3 provide additional risk-bearing capacity and headroom.

Although the Bank is not required to comply with formal regulatory capital guidelines, based on the results of an assessment under different regulatory approaches, the Bank's capital adequacy is projected to be well in excess of the minimum requirements of the Basel II Capital Adequacy Framework both currently and over the CRR3 period. The projected ratios over the CRR3 period emphasise the importance of prudent provisioning levels and growing reserves.

The Bank is projected to be able to withstand the impact of a major shock corresponding to an event occurring at end 2008 with an impact equivalent to about 3.5 times the magnitude of the financial crisis of 1998, although most of its accumulated reserves are projected to be consumed. Whilst captured to some extent in the measurement of regulatory capital, further work is required in the area of Bank-

wide economic capital assessment, in order to reflect the potential impact of other factors, such as losses resulting from foreign exchange risk, the credit risk of Treasury exposures, and operational and legal risks, which could also reduce the Bank's risk-bearing capacity.

In light of the risks discussed above, the Bank must continue to rely on a strong capital base, prudent financial policies that support conservative provisioning, strong liquidity, long term profitability and the build up of reserves to permit continued operational activity taking account of significant medium term risks arising from its projects, from uncertainty in some sectors and countries of operations, and from volatility of the financial markets.

